The purpose of this paper is to propose an alternative way to establish lender yields on government loans, i.e. Stafford, PLUS, and Consolidation loans.

There are three policy objectives that must be served by such alternative proposals:

i) To make the interest on government loans as low as possible
ii) To make student loans accessible to a broad class of students, including underrepresented students
iii) To keep lender yields attractive enough for lenders to offer student loans in adequate supply, yet not excessive.

Rates for government loans have been set by legislation since 1972. Some lenders have argued that the legislated rates are too low to make student lending attractive. Some studies by the CBO and the Department of Treasury question this premise. Nevertheless, the government has accommodated this concern from lenders by offering them special allowances – payments, effectively – to supplement the revenues lenders make from interest payments from borrowers.

A key component of the proposal herein is to determine the lender yields through a competitive auction that employs market forces – rather than through a legislative tug and pull between lobbyists and the government. The behavior of the market proves that lender returns are currently adequately attractive to generate ample interest from lenders – since, in fact, lenders have been willing to make student loans in ample supply. But are the returns excessive? Market behavior from this past year has suggests that they might be, with lenders cutting up front fees and sometimes even interest rates in order to increase their originations. This suggests that borrowers (and perhaps taxpayers as well) might benefit from a more competitive way of determining lender yields than the status quo. Some have suggested that such an atmosphere would scare lenders away from student lending – but contradicts the hard empirical evidence of this past year, while also raising the question of why competition in other areas of lending has not caused a dearth of willing lenders.

<u>The Proposal: A Secondary Market Loan Auction</u>

The following points outline an alternative proposal for determining lender yields:

- The federal government would originate Stafford, FFEL, and Consolidated Loans.
- The government would hold the loans until it saw fit, package them into loan portfolios, and sell them into the secondary markets.
- Borrower interest rates would continue to be set by the federal government. Lenders that deem the return from these rates adequate would bid at par. Lenders that deem the return from these rates to be excessive would bid above par. And otherwise, lenders would bid below par.
- Government loans would have a guarantee against death, disability, default, or bankruptcy – or perhaps no guarantee at all. Presumably, which was actually the case would affect the bids the government received.
- The federal government would determine how the loans would be packaged into portfolios.
- (Note: Were the government to move direct loans, they too could be sold through a secondary market auction – with or without the government guarantee).

This model would perhaps be ideally manifested in a web environment. Such an environment would enable the government to conduct its auctions in such a way that made them accessible to the broadest possible range of potential bidders at minimal cost. The environment could come equipped with state of the art analytical/actuarial tools that would allow a broad class of potential bidders – and not just the elite few with the resources to develop such tools in house – to analyze the portfolios in order to make fully informed bids. And the web environment could include a web interface for borrowers, allowing them to be fully informed of (how to fulfill) their repayment obligations and generally to avoid the confusion associated with repayment or that an auction would (some have argued) bring.

The secondary market loan auction would focus competition on price. This contrasts with the current competitive focus, which is essentially in services to financial aid officers. In the past year, we have seen hard empirical evidence that such price competition would actually result in lower prices – which would serve the government policy objective of minimizing the rates paid by student and parent borrowers (i.e. it would serve policy objective i), listed above).

The secondary market loan auction would also serve the government objective providing access to loans for underserved segments of the population. The current market dynamic makes “cherry picking” attractive. By originating loans and controlling how they are bundled into portfolios before they are sold into the secondary markets, the government would effectively preclude cherry picking.

The secondary market loan auction would also empower the government to assess the significance/need of government guarantees or subsidies. A current premise is that the government guarantee/subsidy is necessary to keep players in the financial aid space engaged. By seeing the how the market responds to the auction, the government can make a more informed of what degree of subsidy or guarantee is necessary to insure this engagement.

Gail Norris raises some issues with the model advocated here in his proposal to the market mechanisms committee. One is that the secondary market loan auction advocated in this paper would “require complex bureaucratic measures to avoid splitting loans for individual borrowers still in school”. This would not be true if the government simply held loans until the students were out of school, or entered repayment. Norris also argued that this model would “eliminate the competitive incentives originators and holders of the loans presently have to provide both best possible services and cost advantages to borrowers from origination through payoff and best possible services to schools”. It is obviously false that forcing competition on price would “eliminate competitive incentives...to provide...cost advantages to borrowers” – how could a price driven auction undercut the motivation to offer best price? And even granting the premise that the model here advocated would “eliminate competitive incentives...to provide...best possible services to schools” – and it is not clear why this would be true either – this would be a problem that could be remedied simply by making adequate services to schools a condition of the bids. This much said, it would appear that Norris’s concerns about the model here endorsed could be addressed simply.

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